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C O N F I D E N T I A L SECTION 01 OF 03 KYIV 000483

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TAGS: [EFIN](#) [EREL](#) [ETRD](#) [PGOV](#) [PREL](#) [XH](#) [UP](#)

SUBJECT: UKRAINE: STELMAKH RETURNS, LASHES TYMOSHENKO

REF: A. KYIV 155

[1](#)B. KYIV 471

[1](#)C. KYIV 421

Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4 (B) AND (D)

Summary

[1](#)1. (C) National Bank of Ukraine (NBU) Governor Stelmakh has returned to the political scene, and appears to have again taken clear control of the central bank. A reputable newspaper has claimed that President Yushchenko and PM Tymoshenko have agreed to keep Stelmakh at the NBU until the presidential elections. Stelmakh officially returned from "vacation" on March 10 after the Constitutional Court confirmed that the Rada had overstepped its authority when it voted to oust the Governor in January. In a March 12 meeting with the Ambassador, a visibly energized Stelmakh said President Yushchenko's and PM Tymoshenko's jointly announced intentions to meet IMF conditionalities were an encouraging development. At the same time, he claimed Tymoshenko could derail the agreement in the Rada and skillfully pin the blame on Yushchenko.

[1](#)2. (C) Stelmakh told the Ambassador that the NBU was moving forward on bank recapitalization. Nadra Bank would be the first bank to get publicly funded capital, yet Tymoshenko was inhibiting the NBU's approach to Nadra over unfounded fears that Dmitry Firtash wanted to take control of the bank, Stelmakh said. The NBU had enough reserves to meet the IMF stipulated floor on March 31, he said. The current account would roughly balance out this year, yet massive debt repayments would remain a challenge for Ukraine. Although loan portfolios would deteriorate further, continued deposit withdrawals were the biggest short term threat to the banking system. The NBU Governor asked whether the international community might consider a \$1 billion loan to Ukraine's Deposit Insurance Fund, which he suggested was more of an urgent need than funding for bank recapitalizations. Many will not be happy that Stelmakh is back, but the NBU now appears to have the decisive leader that was so severely lacking in recent weeks. End summary.

An Energized Stelmakh Returns from "Vacation"

[1](#)3. (C) NBU Governor Volodymyr Stelmakh officially returned from his extended "vacation" on March 10. Two days later, during a meeting with the Ambassador, the visibly energized Stelmakh gave every indication that he was again firmly in control of the NBU and confident of his political future. The central bank had been leaderless since Stelmakh disappeared from public view in late January, ostensibly to go on leave but in reality stepping aside as PM Tymoshenko

and President Yushchenko fought over his political future. The already widespread criticism over his handling of the economic crisis had intensified in the weeks prior to his departure, particularly from Tymoshenko and her BYuT faction in the Rada, and had culminated in a meaningless yet politically symbolic Rada vote to oust him (ref A). Stelmakh returned to the NBU just days after the Constitutional Court confirmed Yushchenko's claim that the Rada had no authority to remove him, and following a report in a reputable newspaper that cited unnamed sources in the Presidential Secretariat to claim that Yushchenko and Tymoshenko had agreed to keep Stelmakh as NBU Governor until after the upcoming presidential elections.

#### Tymoshenko's "Lack of Sincerity"

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14. (C) During his meeting with the Ambassador, Stelmakh repeatedly lashed out at Tymoshenko and what he called her "lack of sincerity" on issues related to the economic crisis. He said the March 11 meeting with Yushchenko and Tymoshenko (ref B) was a positive step towards securing the IMF's return to Ukraine, yet he doubted whether Tymoshenko would follow up on the political commitments she made during the meeting. Stelmakh speculated that Tymoshenko would introduce the needed legislation to raise excise taxes, lower pension fund spending and remove paragraphs 84 and 86 of the budget law, yet work behind the scenes to thwart passage of most, if not all, of these measures. He said Tymoshenko would work to ensure that a sufficient number of OUSD deputies, upon whose votes the coalition depended, would refuse to support the measures. Tymoshenko could then pin blame on Yushchenko for

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ostensibly failing to deliver the votes of his political supporters.

15. (C) Stelmakh said he understood the difficulties making further budget cuts, yet he said Tymoshenko and Rada speaker Lytvyn had no interest to fight the country's "social appetite" for large-scale social spending. The Party of Regions supported both Tymoshenko and Lytvyn in this regard, he said, which created further challenges to further spending cuts in this year's budget.

#### Bank Recap to Begin, Nadra to Get State Funds

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16. (C) Stelmakh said the NBU would in the coming week formally determine the additional capitalization needed by the first 20 banks that underwent the diagnostic tests required by the NBU. Existing shareholders would provide the needed capital in most cases, he said, adding that Nadra Bank would be the first to actually need capital from the GOU. Tymoshenko was making it difficult for the NBU to move forward with a public recapitalization of Nadra Bank, Stelmakh said, because she had asked the Prosecutor General's office to initiate an investigation into the NBU's treatment of Nadra. Tymoshenko was fearful that oligarch Dmitry Firtash was trying to gain control of the bank, yet the NBU had no indication that he was involved, Stelmakh said. (Note: Firtash, co-owner of gas intermediary RUE, is a bitter political foe of Tymoshenko and purported to be close to President Yushchenko. End note). Tymoshenko was telling the NBU that all banks except Nadra were eligible for GOU-funded recapitalization, Stelmakh claimed. Moving forward quickly to prevent Nadra, with its UAH 12 billion of deposits (about \$1.5 billion), from defaulting was being unnecessarily hindered because of Tymoshenko's actions, he added.

17. (C) Stelmakh confirmed that the March 11 meeting also approved the creation of an interagency council that would oversee the bank recapitalization and resolution process. Tymoshenko would chair the council, the NBU would be an active participant, and the IMF and World Bank would have observer roles to ensure that GOU actions adhered to their

expectations and conditionalities.

#### Banking Consolidation Necessary, But Not Easy

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¶8. (C) Stelmakh said the banking sector was in need of serious consolidation, yet the NBU's existing regulatory authority did not give it the proper tools to proactively encourage bank mergers. The NBU can force consolidation when banks fail to meet regulatory requirements, but has far less leverage otherwise. Reforms requiring all banks to become open joint stock companies introduce further legal challenges to forced change of ownership he added. Capital adequacy ratios (CARs) were still at a comfortable 13-14 percent in the banking sector, far above the 10 percent floor set by the NBU. It would be easy for the NBU to force mergers once banks fell below the floor, but far more difficult as long they remained above it. The NBU was currently thinking through different models to accelerate consolidation. These included 1) creating a legal basis for the state-owned Ukreximbank and Oschadbank to take over smaller banks; 2) changing existing bank refinancing rules; under one model now being discussed, the NBU would only refinance larger banks. These, in turn, would finance smaller banks. If the smaller banks failed to return the debt, the larger banks could absorb them as affiliates. In any case consolidation was inevitable, but was a process that would take several years, he said.

#### Deposit Withdrawals Now the Major Problem

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¶9. (C) Stelmakh acknowledged that CARs would continue to deteriorate in the coming months, yet said that deposit withdrawals were now the biggest short term danger for the banking system. Deposit flight in hryvnia was more serious than deposit flight in foreign currencies, he said. He asked the Ambassador whether the international community might consider a \$1 billion loan to Ukraine's Deposit Insurance Fund, which he said was currently more urgent than external funding for expected bank recapitalizations. Stelmakh argued that such a loan would help reestablish trust in the banking system and help the NBU and GOU stem deposit flight. The Ambassador said he would forward the idea to Washington.

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#### Foreign Reserves

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¶10. (C) The Governor said that, as of March 11, the NBU had \$23.6 billion of net foreign exchange reserves, comfortably above the \$21.8 billion floor needed by March 31 in accordance with the IMF conditionalities. The NBU had lost about \$16.5 billion in reserves since the beginning of the crisis, he said. Of this amount, \$8 billion went to repay external loans, \$6 billion "disappeared into the socks of the population," \$2 billion went to Naftohaz to repay debts to Gazprom (ref c), and \$500 million went to meet the accelerated repayment of the Ukravtodor loan to Morgan Stanley. The \$4.5 billion that the NBU had already received from the IMF was not included in the \$23.6 billion. The NBU had already invested the IMF money in sovereign G7 debt and had no intention of ever using it, he claimed.

¶11. (C) Looking forward, the NBU was now confident that the current account would more or less balance out this year, he said. Meeting the expected sizable deficit in the capital account would be more of a challenge, yet was realistic, he said. Two companies might need significant NBU support, Stelmakh added. Naftohaz would need sizable foreign exchange to pay for gas imports, and mobile telephone operator KyivStar would need \$1.5 billion for dividend payments to foreign shareholders that had been held up for 5 years in a court case that was now resolved. The NBU would ensure that both companies could meet their commitments if the market

could not provide enough foreign exchange, he said.

Naftohaz

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¶12. (C) Stelmakh said that many observers in Ukraine had criticized the NBU for facilitating Naftohaz's payments to Gazprom (ref C), yet the NBU had no realistic alternative. The NBU provided only six-month liquidity to Ukreximbank and Oschadbank for onward lending to Naftohaz, he said. Naftohaz will be forced to pay back the loans during the course of the year, and can only do so by raising gas prices. Tymoshenko was angry when she finally understood what the NBU had done, Stelmakh said. According to him, Tymoshenko "thought she could walk away and forget about the problem" once the NBU had enabled Naftohaz to meet its debts to Gazprom.

Comment

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¶13. (C) The political infighting between Tymoshenko and Yushchenko over the NBU, and the absence of a strong NBU leader during the current time of crisis, had been universally criticized both in Ukraine, and among that international donor community that is now being asked to provide Ukraine with a multi-billion budget support package. If Stelmakh's energy and self-confidence are any reflection of his political status, then it appears that the leadership question at the NBU has been resolved. Many observers may not be happy that Stelmakh is back in the saddle, but at least the NBU has a decisive leader, and the political wrangling over him has notably subsided, at least for the moment. End comment.

TAYLOR